THE RAILROAD WEEK IN REVIEW
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"Understanding how to be a good investor makes you a better businessman" – Charlie Munger, as cited in Kiplinger's Magazine, Jan 2006, p 58

CP Redux. Sometimes the best part of the conference call comes during the Q&A. Toward the end of the session the topic turned to customer behavior in the context of asset management. Fred Green got it exactly right when he said, "There are always the outliers blindly objecting to everything," meaning that small minority of customers who see evil in anything the railroad does to improve ROA. And if you don't do their bidding, you're against them.

Well, as I see it the guy who invests in the asset gets to say how that asset is best used. Green again: "Horse-trading tends to favor those who have something to trade." To which Rob Ritchie added, "We will price around those who do not understand the full logistics supply chain." By that I take it CP will price to those who can turn the assets and those who cannot appreciate the value of proper asset utilization may find themselves priced out of the market.

Moreover, Larry Kaufman, in his excellent BNSF History, *Leaders Count*, writes, "The fundamental difference between the new management and the old was that the new people saw themselves as asset managers rather than railroad operators." Happily, the new has won out as we saw at the October 2005 BNSF shortline meeting (WIR 10/28/2005). Signs that asset management is the new mantra for Class Is, shippers and shortlines alike abound: COTs, LOGs, GCO and others of their ilk.

I'm glad Rob Ritchie finally came out and said it in a public forum: These are the rules we follow to provide maximum transportation value to the maximum number of customers. If you find them untenable, please feel free to look elsewhere. In other words, CP is not looking for revenue regardless of cost. Others would do well to follow Rob's lead.

KCS and NS will form a joint venture to upgrade service and capacity on the "Meridian Speedway." It's a 70% KCS, 30% NS deal with the former contributing its 320-mile rail line and NS putting in $300 mm in capital improvements - signal systems, run-arounds and stretches of double track, e.g. -- over four years. KCS will continue to operate the line though NS will be the sole provider of certain intermodal services. See also www.kcsi.com for more information.

Independent analyst Tony Hatch writes, "I am excited by today's news on the joint venture involving the Meridian Speedway for a number of reasons:

1. *It is cooperative*, following the likes of alliances, routing protocols and the (Chicago) CREATE project, sadly under-funded. That means it is not a sign of consolidation but rather it obviates the need for such disruptive measures.

2. *It is innovative* – both sides are bringing to the table their own strengths – track and location (KCS) and funding as well as intermodal marketing (NS).

3. *It is a sign of investing in growth* – along with today's press release from CN on their additional plans for 2006 capex, another sign of the health and prospects of the industry.

4. *It adds growth capacity* to a vital east-west intermodal link, with ramifications felt as far away as Shanghai. KCS, with its focus on Mexico, has been spending on the Speedway but is very stretched, and the intermodal system as a whole needs capacity in a hurry.

5. *It adds capacity by-passing New Orleans* and the Gulf Coast.

To which I must add, it's the kind of collaboration the industry needs to add value to the transportation service product in the eyes of the customer. Too often we hear how the rails are adding capacity yet rarely do we get a specific customer benefit. IMHO, speeding up the railroad for intermodal lanes also speeds it up for carload business.

KCS in 3Q03 derived two-thirds of its total revenue from the merch side of the house while NS merch carloads brought in 54% of total revenue. It's still largely a single track railroad out there, and if you don't believe it take a look at the Jan 2006 *Trains* Map of the Month, pp 54-55. KCS is that line across the northern tier of Louisiana and the squiggly one above the UP in Texas. It's fast, though. A friend just came back from a train-chasing trip there and couldn't keep up with 'em.

The only down side is that coming into Alliance from the north on the former ATSF gets interesting because that line is so chock full. For proof, look at www.rblanchard.com. That BNSF grain train is the third one in a row heading south into Fort Worth, having been backed up almost to the point the KCS comes into that line. (Alliance yard is about five miles north of the photo location).

Be that as it may, it's a welcome addition for both NS and KCS. Bear Stearnes' Ed Wolfe wraps it up nicely: "Norfolk Southern's $300 mm payment assumes almost a $1bn valuation for the Meridian Speedway, a relatively small part of KCS' vast overall U.S. and Mexican network. We believe that KCS' operating lanes, particularly between the U.S. and Mexico, have tremendous strategic value to several larger Class I railroads." Putting it mildly.

Shortline comps are tough to come by. The thought occurs that the publicly traded shortlines and regionals might provide a clue. They do, sorta. The chart following the disclaimer compares the expense lines from the third quarter 10-Qs of FEC (railroad only), GWR, P&W and RRA. It's all pretty straight forward except for fuel and car hire.

Why bother? Because wide deviations form an industry norm point to a need for further study. Unusually high expense for car hire indicates cars are not being turned. Is it that customers are delaying equipment or is a function of rail operations? And high fuel expense could mean a maintenance shortcoming, not shutting down power when not in use, or locos not delivering rated power. Any of these can affect car hire and comp expense if crews are not getting over the road in a timely fashion.

The group does not provide the detail we're accustomed to from the class Is, so you have to ask. Carloads or revenue units are the more usual measure then gross ton-miles, but that's fine too. However, on calling around I discovered that the 10-Q fuel line for FEC reports diesel fuel used in everything from locos to track equipment. UP does something similar, though you can get at the loco number using GTMs and average fuel price paid.

As you can see (P&W had not responded by deadline), FEC burns almost twice as much per unit as GWR and RRA. But then, FEC is a high speed, heavy haul railroad whereas the other two are comprised mostly of smaller lines with lighter volumes and *much* lower speeds. Recall the FEC is one 360-mile straight shot from Miami to Jacksonville.

For my purposes, I'm going to use the smaller numbers as a proxy for shortline fuel consumption. I'd like to hear from other shortline operators whose experience is significantly different. Also, previous models have pegged fuel expense in the six to eight percent range. Fuel prices are up a third or more since then so a revised eight to twelve percent of revenues seems reasonable.

Car hire is something else. FEC and P&W follow the Class I mode and report net car hire (see www.stb.gov.dot, navigate to the R-1s and look at Schedule 410, lines 230, 231). On the other hand, neither GWR nor RRA own fleets big enough to diminish foreign car hire significantly as most loads handled are in OPE (other people's equipment). That's the usual shortline model and previous models have had car hire in the mid-teens. Looks like we're safe here.

Meanwhile, FEC now expects CY 2005 revenue to range between $230 and $235 mm, an increase of 15% to 17% over 2004, and Railway segment operating income is now expected to range between $59 and $61 mm, an increase of 25% to 29% over 2004. This operating income projection is $3 mm higher than previously announced and includes the impact of Hurricane Wilma but not any insurance recoveries or reimbursements.

Upgrades and Downgrades. Bear Stearns on Thursday downgraded **CP** to *Peer Perform* from *Outperform* largely on price appreciation: "We are lowering our rating on CP from Out to Peer Perform as CP is now within 5% of our C06 year end target price. CP is up 32% YTD (vs. 4% for the S&P 500). At current levels we believe the vast majority of CP's expected volume turnaround is already priced into the stock. We see the risk/reward profile now as generally balanced over the next 6-12 months."

Still, CP trades at a PEG ratio of 0.47 and a modest 1.8 price/sales ratio, indicating there is still for revenue and earnings expansion. I think the candor of Rob Ritchie and Fred Green (above) will increase revenue because the product will have more value in the eyes of the customer. At the same time, it's cheaper to run an efficient railroad than an inefficient one. Points off the OR point to better operating income and, all things being equal below the line, improved eps.

And here's an example of why I used the Munger quote. A shortline operator that anticipates the strategic direction of his connecting Class I – and maybe even (gasp!) invests in his connecting Class I -- is going to be a better shortline operator.

Also on Thursday Jason Seidl of CSFB upgraded **RRA** to *Outperform* from *Neutral* with a 12-month price target of $13 based on "several events on the horizon that could warrant an increase in earnings estimates at some point."

He adds, "Recently acquired rail lines from Alcoa have the potential to generate meaningful levels of consolidate free cash flow at RailAmerica -- something we have not yet observed. RRA also stands to continue benefiting from tax breaks on track maintenance initiatives along with improved fuel surcharges sharing from all of the major Class 1 railroads."

As of Friday noon, RRA was down a dime from the gap-up price of $11. I am concerned about RRA's high operating ratio – 89 vs GWR's 80 – and some of the expense items – comp, fuel, casualty, e.g. – on the high side. Shortline operators could benefit from the RRA numbers to find opportunities to sharpen their own operations. Again, watching the stock provides insights at home.

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Shortline and regional RR comps, 3Q05

Item	RRA	GWR	FEC	P&W
Freight Revs	$ 100.6	$ 76.5	$ 58.7	$ 7.4
Other Revs	$ 11.9	$ 28.8	$ 1.2	$ 0.1
Total Revs	$ 112.5	$ 105.3	$ 59.9	$ 7.6
Ops Exp				
Comp & Benefits	$ 34.4	$ 31.4	$ 14.9	$ 3.7
Car Hire (1)	$ 13.9	$ 9.3	$ (0.7)	$ 0.3
Purch Svcs	$ 8.8	$ 7.6	$ 2.3	$ 0.5
Diesel Fuel (2)	$ 12.7	$ 10.7	$ 6.6	$ 0.6
Cas & Ins	$ 7.5	$ 4.5	$ 1.5	$ 0.2
Materials	$ 2.8	$ 5.1	$ 3.0	$ 0.9
Joint Facilities	$ 3.1	$ -	$ -	$ 0.2
Other Exp	$ 9.4	$ 8.9	$ 3.0	$ 0.4
Depreciation	$ 7.7	$ 7.1	$ 5.5	$ 0.7
Total Ops Exp	$ 100.3	$ 84.6	$ 36.1	$ 7.4
RR Ops Inc	12.20	20.70	23.80	0.14
Ops Ratio	89.2%	80.3%	60.3%	98.2%
NA Route miles	8,900	5,300	351	545
mm gals of fuel	6.90	5.38	3.61	
price per gal (2)	$ 1.840	$ 1.990	$ 1.730	
Revenue Units	318,983	199,075	131,300	
Gallons/rev unit	22	27	48	

(1) FEC, P&W report net car hire, i.e car hire paid out less CH credits from other roads

(2) Item is all fuel; FEC loco fuel expense $6.24 mm

Percentages of Total Revenue

Item	RRA	GWR	FEC	P&W
Freight Revs	89.4%	72.6%	98.0%	98.2%
Other Revs	10.6%	27.4%	2.0%	1.8%
Total Revs	100.0%	100.0%	100.0%	100.0%
Ops Exp				
Comp & Benefits	30.6%	29.8%	24.9%	49.0%
Equip Rents	12.4%	8.8%	-1.2%	3.7%
Purch Svcs	7.8%	7.2%	3.8%	6.0%
Diesel Fuel	11.3%	10.2%	11.0%	7.5%
Cas & Ins	6.7%	4.3%	2.5%	3.2%
Materials	2.5%	4.8%	5.0%	11.9%
Joint Facilities	2.8%	0.0%	0.0%	2.8%
Other Exp	8.4%	8.5%	5.0%	4.9%
Depreciation	6.8%	6.7%	9.2%	9.1%
Total Ops Exp	89.2%	80.3%	60.3%	98.2%
Gross Margin	10.8%	19.7%	39.7%	1.8%

Source: Company 10-Qs, conversations with management